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CHARLES ELMO

IN THE

SUPREME COURT

OF THE

UNITED STATES.

OCTOBER TERM, 1934.

No. 170.

Guy T. Helvering, Commissioner of Internal Revenue,

Petitioner,

vs.

Twin Bell Oil Syndicate,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

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OPINION BELOW.

The findings of fact, opinion and decision of the United States Board of Tax Appeals [R. 14-27] are reported in 26 B. T. A. 172. The opinion of the Circuit Court of Appeals [R. 192-214] is reported in 70 Fed. (2d) 402.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered April 12, 1934 [R. 215]. A petition for certiorari was filed July 12, 1934, and granted October 8, 1934. Jurisdiction is conferred upon this court by section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

Whether, in determining the gross income for the purpose of applying the provisions of section 204(c) (2) of the Revenue Act of 1926, which provides for an allowance for depletion based on 27½ per cent of gross income, the taxpayer's actual gross income should be reduced by royalties paid.

STATUTES AND REGULATIONS INVOLVED.

The applicable provisions of the Statutes and Regulations involved are set forth in the Appendix hereto.

STATEMENT.

The taxpayer is a California syndicate organized in 1922 for the purpose of acquiring a certain oil and gas lease and operating it. [R. 36-41.] Both the Board and the court below have held that the syndicate is to be treated as a corporation for Federal income-tax purposes.

The original lessee of the properties was one F. A. Andrews, who secured a twenty-year lease from the owner, W. O. Batson, in December, 1921. In addition to certain monthly rentals to be paid until drilling should commence

the lessee agreed to pay as rental or royalty for the land "one-sixth (1/6) of all oil produced and saved therefrom, said payment to be made in money or in kind at the lessor's option." [R. 86-90.]

On February 10, 1922, this lease was assigned by F. A. Andrews to Thomas H. Lipps. The agreement or assignment contained the provision that, in addition to the payment of the one-sixth royalty specified in the original lease, the lessee would pay a one-twelfth royalty to the assignor. [R. 95-97, 197.]

On April 25, 1922, Lipps assigned all his right, title and interest in the lease to the trustees of the syndicate, who agreed to comply with all of the terms and conditions of the original lease and also of the assignment by Andrews. [R. 104-105.]

The taxpayer has never acquired any property other than the lease assigned to it by Lipps and has never sold any part of such lease. The taxpayer had a contract under which it sold all the oil produced to the Associated Oil Company. [R. 42.] The taxpayer entered on its books the payments received from the sale of its oil in an "Oil Runs Account" and charged against such account the royalties paid to Batson and Andrews. [R. 49-50.]

The one-sixth royalty paid to Batson and the one-twelfth royalty paid to Andrews during the taxable years 1925, 1926 and 1927 were as follows [R. 18]:

Year	Batson Royalties	Andrews Royalties
1925	$159,853.20	$79,926.60
1926	143,253.02	71,626.51
1927	70,946.34	35,473.17

In the audit of the taxpayer's returns for 1925, 1926 and 1927, the Commissioner held that the above-mentioned royalties should be deducted from the gross income from the wells before computing the 27½ per cent deduction for depletion allowed under section 204(c) (2). [R. 18-19.]

The Commissioner determined deficiencies as the result of this adjustment of the depletion allowance and other adjustments and the taxpayer appealed to the United States Board of Tax Appeals.

The Board sustained the Commissioner's allowance for depletion, but decided against the Commissioner on another issue. Both parties appealed. The Circuit Court of Appeals for the Ninth Circuit reversed the Board on the issue concerning depletion, which was one of two issues in the taxpayer's appeal. The Circuit Court held that the 27½ per cent deduction should be computed on the gross income of the taxpayer without deduction for the rents and royalties. The other issues involved in the case were decided for the Government and are not here involved.

SUMMARY OF ARGUMENT.

1. Amounts of royalties paid are part of taxpayer's gross income (*Comar Oil Co. v. Burnett,* 64 Fed. (2d) 965), and, as section 204(c) (2) provides that the depletion allowance shall be 27½ per cent "of the gross income," there is no authority for reducing the gross income upon which the 27½ per cent is to be computed, by royalties paid.

The taxpayer's gross income includes the gross proceeds received from the sale of its oil and gas. (*Darby-Lynde Co. v. Alexander*, 51 Fed. (2d) 56, 59.) That the term "gross income" as used in section 204(c) (2) of the Revenue Act of 1926 is to be so interpreted is impliedly affirmed by the provision of said section when re-enacted as section 114(b) (3) of the Revenue Act of 1932, which latter section provides that the depletion allowance shall be 27½ per cent of the gross income . . ., *"excluding from such gross income* an amount equal to any rents or royalties paid . . .". If the amounts of rents and royalties paid were not part of the gross income before payment of said rents and royalties, there would have been no necessity for the exclusion from gross income clause contained in section 114(b) (3) of the Revenue Act of 1932.

2. Section 204(c) (2) does not provide for a "basis" for depletion but provides for the amount of an "allowance" for depletion to which each taxpayer is entitled, and thereby provides its own "apportionment" of the depletion allowance authorized by it.

It was the intent of the Legislature when section 204(c) (2) was enacted that under such statute, every person having an interest in oil and gas property, whether a legal title or an economic interest (*Palmer v. Bender*, 77 L. Ed. (Adv. Op.) 338), should be entitled to an arbitrary allowance for depletion, thus eliminating the difficulties of administration of a method of computing depletion allowances requiring intricate calculations.

Section 214(a) (9) (or 234(a) (8)) cannot be read as a part of section 204(c) (2) and was not intended as a part of the latter section.

Section 234(a) (8) cannot be applied as a restriction upon the amount of the depletion allowance computable under section 204(c) (2) since the depletion allowance under the latter section is the minimum amount allowable under the statutes.

3. The provision contained in section 234(a) (8) for equitable apportionment of a depletion allowance between lessor and lessee, applies only to the depletion allowance computed under section 234(a) (8).

The provision that the depletion "be equitably apportioned" was not intended to require the distribution of an aggregate depletion allowance to all parties interested in an oil and gas property, but was intended to authorize depletion allowances to lessees. The depletion allowance to lessor and lessee has at all times under Commissioner's regulations been separately computed. (Art. 203 and 204, Reg. 69.)

Section 204(c) (2) being a statute covering a special subject matter, cannot be controlled or modified by the terms of section 234(a) (8) which is general in nature. (*D. Ginsberg & Son v. Popkin,* 285 U. S. 204.)

Under the theory advanced by the Commissioner and the Board of Tax Appeals it must be implied that an exclusion clause is part of section 204(c) (2), to provide for the exclusion of royalties paid from gross income. Since such an exclusion cannot be read or implied in the clear import of the language used in the statute, the Board's construction of the statute violates the rule of statutory construction that the terms of a statute cannot be extended beyond the clear import of the language used. (*Gould v. Gould,* 245 U. S. 151.)

4. Section 114(b) (3) of the Revenue Act of 1932 which contains an amendment of section 204(c) (2), Revenue Act of 1926, and section 114(b) (3) of the Revenue Act of 1928, is a declaration of new law. It repeats the provisions of the two earlier statutes but adds the provision that there should be excluded "from such gross income an amount equal to any rents or royalties paid." The fact that the exclusion clause is new in the Revenue Act of 1932, and excludes a matter clearly included by the general terms of the section without the exclusion clause, is indicative of a declaration of a change in the law under the previous statutes. Ordinarily, statutes establish rules for the future, and they will not be applied retrospectively unless that purpose plainly appears. (*United States v. Magnolia Co.*, 265 U. S. 160, 162; *Brewster v. Gage*, 280 U. S. 327; *Russell v. United States*, 278 U. S.181.) There is nothing in the statute or its legislative history to indicate any purpose that the amendment contained in section 114(b) (3) of the Revenue Act of 1932 should be given retrospective effect.

The amendment in section 114(b) (3) of the Revenue Act of 1932 disproves the Board's theory as to the apportionment of any depletion deduction allowed by section 204(c) (2) of the Revenue Act of 1926. If the Board's theory were applied to section 114(b) (3) of the Revenue Act of 1932, every taxpayer would get a depletion allowance on the basis of gross income from which is excluded royalties paid, regardless of whether he paid any royalty. In other words, under the Board's theory, there must first be computed an aggregate depletion allowance to which all parties interested in the oil and gas wells would get a share, and this computation would be 27½ per cent

of the gross income from which has been excluded the royalties paid, as required by section 114(b) (3). The resulting depletion is then apportioned to lessor and lessee on the basis of their interests under the lease and regardless of what their gross income from the property might be.

This is obviously not the intent of section 114(b) (3). The purpose of the Legislature was to permit each taxpayer, having an interest in an oil and gas property, a depletion allowance of 27½ per cent of his gross income from the property. Congress must have realized at the time the 1932 Act was prepared that because items of royalties paid are included as part of the gross income of the payor, and become gross income to the payee, provision should be made for the exclusion from each respective taxpayer's gross income for the purpose of computing the 27½ per cent deduction, the amount of royalties paid by him, if any, in order to avoid allowing in the future a depletion deduction to several taxpayers on what in effect might be considered the same gross income. The Board's theory of the interpretation of the statute does not give effect to this purpose and creates such an illogical situation that it should not be sustained.

If there is any doubt as to the proper construction of a taxing statute, the doubt should be resolved in favor of the taxpayer, and a construction adopted which is most favorable to the taxpayer. (*Gould v. Gould, supra; United States v. Updike,* 281 U. S. 489; *Burnet v. Niagara Falls Brewing Co.,* 282 U. S. 648.)

5. The legislative history of section 204(c) (2) and the simplicity and clarity of its provisions require its interpretation according to the ordinary meaning of its terms. It is only such an interpretation which will fulfill the pur-

pose of the Legislature that the section should provide a simple means of computing a depletion deduction allowable to each taxpayer having an interest in an oil and gas property.

ARGUMENT.

As has been pointed out in the Statement of Facts set forth in this brief, the lease which was finally assigned to the taxpayer (who is the respondent in this proceeding) provided for the payment to the lessor, as rental or royalty for the use of the land covered by the lease, one-sixth (1/6) of the oil produced and saved from the property. The provision in the lease regarding the royalty payment reads as follows:

> "9. . . . The lessee shall pay as rental or royalty for the use of said land one-sixth (1/6) of all oil produced and saved therefrom, said payment to be made in money or in kind at the lessor's option." [R. 90.]

As additional rent the taxpayer's assignor, in order to secure the assignment of the lease from the original lessee, was obliged to pay one-twelfth (1/12) of the oil produced. The provision of the lease assignment relating to this royalty reads as follows:

> ". . . Party of the second part hereby agrees to perform each and all of the covenants and obligations of said 'Batson' lease agreed to be performed by said F. A. Andrews, one of the parties of the first part hereunder, of every kind and character; and in addition to such performance of said 'Batson' lease, said Thomas H. Lipps, party of the second part hereunder agrees further:

(1) That he will pay to the parties of the first part herein, over and in addition to the one-sixth (1/6) royalty agreed to be paid to the lessors under said 'Batson' lease, one-twelfth of all petroleum, oil, gas and other oil products, and casinghead gasoline, produced and saved from each and all wells on said premises by the party of the second part, said royalty to be paid in lawful money of the United States, or in kind, at the option of the parties of the first part, . . .". [R. 95, 97.]

The lease and assignment thereof were duly assigned to the taxpayer, the Twin Bell Oil Syndicate (respondent in this proceeding). [R. 103.]

Section 204(c) (2) of the Revenue Act of 1926, *supra*, permitted the taxpayer to deduct, as depletion, in the case of oil and gas wells, *27½ per cent of the gross income from the property during the taxable year*. The Commissioner of Internal Revenue, however, interpreted the meaning of gross income, as used in that section of the law, as being the gross income after deducting the royalties paid to the lessor. Consequently, the Commissioner computed the 27½ per cent on a smaller amount as gross income, as a result of which he reduced the taxpayer's deduction for depletion. Taxpayer contended that the computation should be made on its *gross income* before any deduction.

The Board of Tax Appeals, in sustaining the Commissioner, held that section 234(a) (8), which provides for a reasonable allowance for depreciation and depletion and an equitable apportionment of such allowance between the

lessor and lessee, must be read together with section 204 (c) (2) which the Board holds merely specifies the "basis" of a depletion allowance; that by reading these sections together it must be concluded that the 27½ per cent of gross income allowance for depletion is to be equitably apportioned between lessor and lessee; and that therefore of the 27½ per cent of gross income allowable as a depletion deduction, 3/4ths thereof may be deducted by the petitioner who has a 3/4th interest in the oil produced, and 1/4th thereof may be deducted by the lessors and original lessee who had a 1/4th interest in the oil produced.

The United States Circuit Court of Appeals for the Ninth Circuit reversed the Board of Tax Appeals, holding that section 204(c) (2) of the Revenue Act of 1926 provided for an arbitrary allowance for depletion deduction and was not to be controlled in its application by section 234(a) (8); that section 204(c) (2) by its terms clearly provided for a depletion allowance computed at the rate of 27½ per cent of gross income and that, therefore, the gross income should not be reduced by royalties paid.

In support of taxpayer's contentions throughout these proceedings and in support of the decision of the United States Circuit Court of Appeals in this case, the following arguments which have hereinbefore been summarized under the heading "Summary of Argument" are respectfully submitted:

1.

THE TAXPAYER'S GROSS INCOME FROM THE PROPERTY IS THE GROSS PROCEEDS DERIVED FROM THE SALE OF OIL AND GAS PRODUCED.

The Commissioner's contention that the taxpayer's gross income consists of the gross proceeds from the sale of oil and gas produced, reduced by the amount of rents and royalties paid, cannot be supported by the income tax statutes.

Sections 204(c) of the Revenue Act is very concise and contains very simple language. It provides that "In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year." Construing the statute by itself, the only questions in its application to this proceeding is whether the term "gross income" includes amounts paid out of income for rents or royalties for the use of the property.

Under the provisions of the lease and assignment thereof regarding royalty payments the taxpayer was entitled to all of the oil and gas produced from the property and was to make payment to the lessees of certain royalties "as rental or royalty for the use of said land." The taxpayer produced and sold all of the oil and gas produced from the property and out of the proceeds of said sales the taxpayer paid the royalties required under the lease and lease assignment. Its books of records reflect the receipt of the gross proceeds from the sale of oil and gas

as gross income and reflect also the payments of the royalties to the lessor and to the assignor of said lease as deductions. [R. 49.]

The sole question stated in a slightly different form than in the preceding paragraph is whether, for the purpose of computing the depletion allowance based on 27½ per cent of the gross income, the gross income shall be the amount of the gross proceeds from the sale of the oil and gas or whether such gross income shall be the amount of the said gross proceeds less the amount of rents and royalties paid. We submit that the conclusion is inescapable that the taxpayer's gross income from the property is the amount of the gross proceeds derived from the sale of oil and gas produced.

Section 213(a) of the Revenue Act of 1927, *supra,* defines gross income in general as being any form of income, whether from salaries, wages, professions, trades, business, *sales,* dealings in property, interest, rent dividends, or gains or profits, or income derived from any source whatever. The income tax law is so compiled that it defines and explains gross income (section 213, 233) from which shall be deducted what are explained and defined as deductions, such as expenses, etc. (section 214, 234), in order to arrive at what is defined and explained as the net income (section 212, 232), which net income is subject to tax. Amongst the deductions which are to be made from gross income in determining net income there are specified in the Revenue Act (section 214(a) (1)) the items of rents and royalties.

The law has now been definitely established that royalty payments under oil and mine leases are not payments for the purchase of property but are in fact rental payments for the use of the property. (*Von Baumbach v. Sargent Land Co.*, 242 U. S. 503; *United States v. Biwabik Mining Co.*, 247 U. S. 116; *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364; *Burnet v. Harmel*, 287 U. S. 103.)

Under the above referred to sections of the Revenue Act the taxpayer was required to include in its gross income its gross proceeds from the *sales* of its oil and gas, and it was then required to include in its deductions the amounts which it paid as rents and royalties. (*Bogle & Co.*, 5 B. T. A. 541, 552):

> "With reference to the minimum royalties, we are of the opinion that they constitute rent and are allowable deductions. It is well settled that royalties paid under the provisions of mining leases constitute rents. (*Lynch v. Alworth-Stephens Co.*, 267 U. S. 364; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, and *United States v. Biwabik Mining Co.*, 247 U. S. 116; *James R. Parkey*, 16 B. T. A. 441.)"

The question of whether these royalty payments should first be treated as gross income was recently before the United States Circuit Court of Appeals for the Eighth Circuit in the case of *Comar Oil Co. v. Burnet*, 64 Fed. (2d) 965, affirming 24 B. T. A. That court, in its decision that such royalties should first be included as gross income of the lessee, stated the law to be as follows:

"Gross Income.—It will be apparent upon examination of the statute (Section 213(a)) that the term 'gross income' is broad in scope; broad enough to include, in the case of a lessor, rents or royalties paid to him by the lessee, Von Baumbach v. Sargent Land Co., 242 U. S. 503, 37 S. Ct. 201, 61 L. Ed. 460; United States v. Biwabik Mining Co., 247 U. S. 116, 38 S. Ct. 462, 62 L. Ed. 1017; Murphy Oil Co. v. Burnet, 287 U. S. 299, 53 S. Ct. 161, 77 L. Ed. 168; Burnet v. Harmel, 287 U. S. 103, 53 Sup. Ct. 74, 77 L. Ed. 59; *broad enough also to include, in the case of a lessee, rents or royalties paid by him to the lessor owner; and the practice has been to include them as gross income in the return.* United States v. Boston & Providence R. R. Corp. (C. C. A.), 37 F. (2d) 670; International Textbook Co. v. United States (Ct. Cl.), 44 F. (2d) 254; Baton Coal Co. v. Commissioner of Internal Revenue (C. C. A.), 51 F. (2d) 469; Jefferson Gas Coal Co. v. Commissioner of Internal Revenue (C. C. A.), 52 Fed. (2d) 120; Davison v. Commissioner of Internal Revenue (C. C. A.), 60 Fed. (2d) 50; Merillat v. Commissioner, 9 B. T. A. 813; Kekaka Sugar Co., Ltd. v. Commissioner, 13 B. T. A. 690; Ferguson v. Commissioner, 20 B. T. A. 130.

"We are not insensible to the forceful argument of petitioner that neither original royalties nor overriding royalties should be included in gross income of the lessee, sublessee, or transferee. The argument is one, however, which we think should more properly be presented to the Congress than to the courts.

> The inclusion of royalties in the gross income of the lessee not only finds support in the language of sections 233 and 213 of the Revenue Act of 1921, but also in the actual practice as established during a considerable number of years. See cases cited above." (Italics ours.)

These decisions leave little room for doubt that royalty payments constitute part of the taxpayer's gross income and that for purposes of computing a 27½ per cent depletion allowance the gross proceeds derived from the sale of oil and gas produced must be considered the gross income from the property and must not be reduced by the amount of rents and royalties paid. This was the conclusion of the Circuit Court of Appeals in its decision in this case [R. 204-206] and is consistent with the conclusion of the Circuit Court of Appeals for the Tenth Circuit in the case of *Darby-Lynde Co. v. Alexander,* 51 Fed. (2d) 256, certiorari denied, 284 U. S. 266, as follows:

> *"We conclude that the words 'gross income', as used in section 204(c) (2), supra, mean income derived from the sale or other disposition of oil and gas produced,* and not from the sale of the oil and gas properties." (Italics ours.)

We believe that the foregoing argument establishes that a fair interpretation of the section would require the 27½ per cent computation to be made on the taxpayer's gross income from the property before any deductions for royalties paid.

2.

SECTION 204(c) (2) IS AUTHORITY FOR AN ARBITRARY PERCENTAGE ALLOWANCE FOR OR "APPORTIONED" TO EACH TAXPAYER. IT CANNOT BE CONSTRUED AS PART OF SECTION 234(a) (8) AND THE DEPLETION ALLOWANCE AUTHORIZED BY IT CANNOT BE RESTRICTED BY ANY PROVISION OF SECTION 234(a) (8).

The Commissioner contended, and his contention was sustained by the Board of Tax Appeals, that even though "gross income" included amounts of royalties paid, section 204(c) (2) merely prescribed a basis for computing a depletion allowance,—that that section and section 234(a) (8) of the Revenue Act of 1926 had to be read together as a single statutory provision authorizing the depletion allowance, and that the depletion computable under section 204(c) (2) was particularly restricted by that part of section 214(a) (9) (or 234(a) (8)) which provides "in the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee." The Circuit Court of Appeals reversed the Board and concluded [R. 207] that section 204(c) (2) provided for an "allowance" for depletion and was not to be considered a part of section 234(a) (8).

The conclusion of the Circuit Court is well supported by the legislative history of the sections involved, by the construction and wording of the sections, by other judicial decisions, and by the impracticability of application of a contrary conclusion.

Legislative History of the Provision of Section 214(a) (9) (or 234(a) (8)), Revenue Act of 1926—"In the Case of Leases the Deduction Allowed by This Paragraph Shall Be Equitably Apportioned Between the Lessor and Lessee"—and Reason for Its Retention in the Revenue Act of 1926.

Prior to the Revenue Act of 1926, taxpayers were entitled, under section 204 (b) and (c) of the Revenue Act of 1924 and section 214(a) (10) of the Revenue Acts of 1918 and 1921, to a depletion allowance in case of mines, oil and gas wells discovered by the taxpayer on or after March 1, 1913, computed on the basis of the fair market value of the property at the date of discovery; and where property was acquired prior to March 1, 1913, on the basis of the fair market value on that date. Of the fair market value on the basic date the lessor and lessee had certain proportions according to the value of their respective interests. The total depletion allowable was the depletion of that basic value and provision was then made in all revenue acts enacted after the Revenue Act of 1916 for the equitable apportionment of the allowable depletion between the lessor and lessee.

Under the Revenue Act of 1916 it was first ruled that lessees were not entitled to a depletion deduction (*Weiss v. Mohawk Mining Co.*, 264 Fed. 502; but see later decision of United States Supreme Court in *Lynch v. Alworth-Stephens Co.*, 45 Sup. Ct. 274, decided after enactment of 1918 Revenue Act.) Congress therefore inserted the provision of section 214(a) (10) providing for equitable apportionment of the depletion deduction between lessor and lessee to enable lessees to receive the benefit of the depletion allowance. (Report 767, Committee on

Ways & Means, House of Representatives, on Revenue Bill of 1918, p. 10: "The bill also corrects an inequality of the present law by providing for an equitable apportionment of the depletion allowance between lessor and lessee.")

When the 1926 Act was enacted the provisions for a computation of depletion on discovery values in the case of oil and gas were eliminated. However, the discovery depletion was still permitted in the case of mines, under the provisions of section 204(c) (1) of the Revenue Act of 1926, and depletion on the basis of March 1, 1913 values was still permitted under the provisions of section 204(b) of the Revenue Act of 1926. It was therefore consistent that the provision of section 214(a) (9): "in the case of leases the deduction *allowed by this paragraph* shall be equitably apportioned between lessor and lessee"—be retained.

Legislative History of Section 204(c) (2) of the Revenue Act of 1926 and Reason for Its Enactment.

At the hearings before the Committee on Finance, United States Senate, minutes of which are recorded in a report of said hearings on House Report 1—Revenue Act of 1926, held January 4, 5, 9, 12, 13, 14, of 1926, discussion was had between members of that committee and representatives of the Internal Revenue Bureau regarding the difficulties of administration of the discovery depletion provisions of the Revenue Acts and the advisability of substituting therefor an arbitrary percentage allowance of depletion. (See pages 177, 197, 198, 199, 200 of the report of the hearings.) In report No. 52 of the Senate Committee on Finance concerning the Internal

Revenue Bill of 1926, on page 17, the Finance Committee made the following recommendation regarding discovery depletion in the case of oil and gas wells:

> "The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovery well. In the interest of simplicity and certainly in administration your committee recommends that in the case of oil and gas wells the allowance for depletion shall be 25 per cent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained."

When the Revenue Bill of 1926 was finally enacted it gave effect to the recommendation of the finance committee above quoted, excepting that the rate for depletion was changed to 27½ per cent of the gross income. This history of the enactment of section 204(c) (2) must show that the section was intended to allow a purely arbitrary deduction for depletion in the case of oil and gas wells.

This inference would seem authorized by the language of the Supreme Court in the case, *United States v. Dakota-Montana Oil Company,* 288 U. S. 459, 461, 466:

> "But the 'discovery value' provision was eliminated from the Act of 1926, which is applicable here, and the taxpayer was permitted to calculate depletion on the basis of cost alone, section 204(c), or else to deduct an arbitrary allowance, fixed by the statute, without reference to cost or discovery value, at 27½ per cent of gross income from the well.
>
> * * * * * * * *

"It was eliminated under the 1926 Act, being no longer necessary, as the statute omitted the 'discovery value' provision and substituted the arbitrary percentage allowance for depletion."

Section 204(c) (2) Is Complete in Itself and Provides Not for a Basis for Depletion but for the Amount of an Allowance for Depletion to Which Each Taxpayer Is Entitled and Thereby Provides Its Own Apportionment of the Depletion Allowance Authorized by It.

The Board in its decision stated that section 204(c) (2) merely provided a *basis* for the depletion which would be allowable under section 234(a) (8).

The Circuit Court of Appeals ruled otherwise, holding that section 204(c) (2) authorized an arbitrary percentage *allowance* for depletion. We believe the court has given ample argument in its decision in support of this conclusion [R. 204-205] and we respectfully submit its conclusion should be sustained.

The Commissioner argues—

"It is unreasonable to suppose that Congress intended that a multiplication of interests in the property should result in a greater allowance for depletion than the owner himself would be allowed if he operated the property. It is far more reasonable to assume that Congress intended that the percentage deduction allowable to all having an economic interest should amount in the aggregate to 27½ per cent of the gross income from the property, that is, from production, and that this amount should be equitably apportioned between all having such interest. There is no apportionment on any other theory."

The premise upon which this argument is founded is that section 204(c) (2) provides for a predeterminable definite aggregate depletion allowance to all taxpayers interested in an oil and gas property. We do not believe such a premise can be sustained. Congress intended that under section 204(c) (2) *each taxpayer* should be entitled to an *arbitrary* depletion allowance subject to certain restrictions. It is fundamental that the taxing statutes govern the tax computation of each person or entity subject to tax. Nowhere do the taxing statutes recognize a group of persons having royalty interests in an oil well as a separate taxable entity. Section 204(c) (2) must therefore apply to each taxable person, and under it each taxable person may compute his depletion allowance on the basis of 27½ per cent of his gross income from the property, regardless of the amount of gross income realized by any other person interested in the property. As to "apportionment," if the requirement of apportionment must be met, we submit that section 204(c) (2) by its terms effects the apportionment by providing that each taxpayer be allowed depletion on the basis of 27½ per cent of his gross income from the property not to be in excess of 50 per cent of his net income. Some of the taxpayers interested in the property may find their depletion allowance restricted by the 50 per cent of net income provision; others may not be so restricted; others, such as operating lessees, may suffer losses in the operation of the property and thus be entitled to no depletion under this section. If we must find the aggregate arbitrary allowance under section 204(c) (2), it would be the total of the "apportioned" *arbitrary allowances* computed as indicated above. Whether that aggregate would

be more or less, and it might be either, than a single operating owner of the property might have been allowed, is immaterial.

If this Honorable Court should affirm the Circuit Court's conclusion that section 204(c) (2) was a statutory provision complete in itself, and authorizing an allowance for depletion, we feel it would follow that the provisions of section 204(c) (2) would in no wise be controlled by section 234(a) (8) excepting in one event which would be the instance when the depletion allowance computed under section 214 (234) would be *greater* than the allowance computed under section 204(c) (2) in which case the greater allowance would be the depletion deduction to which the taxpayer is entitled. However, in the event this court should not agree with this conclusion, we respectfully submit the following argument to show that sections 234(a) (8) and 204(c) (2) are independent of each other and are not to be read together as a single statutory provision authorizing a depletion allowance.

Both Section 214(a) (9) (234(a) (8)) and Section 204 (c) (2) Provide for the Allowance for Depletion.

It is respectfully submitted that section 204(c) (2) is a complete and separate and distinct statutory provision for the deductibility of a depletion *allowance* in the case of oil and gas wells. Under this construction section 234(a) (8) is authority for the allowance of depletion on the basis of cost or March 1, 1913 value, or discovery value in the case of mines, which bases are authorized under section 204(c) and (c)(1); and section 204(c) (2) is authority for the allowance of an arbitrary amount of depletion in the case of oil and gas wells.

Section 204(c)(2) presupposes the existence of another stautory provision authorizing a depletion computation, for it contains the proviso that "in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." Since section 204 (c) (2) by its own terms authorizes *the allowance* for depletion at the rate of 27½ per cent of gross income, a computation without reference to section 204(c) (2) must be a computation under another section authorizing an allowance for depletion.

The Depletion Allowance Computed Under Section 204(c) (2) Is the Least Amount Allowable as a Depletion Deduction. Therefore, Section 234(a) (8) Cannot Restrict Section 204(c) (2) so as to Reduce the Depletion Deduction Below the Allowance Computed Under Section 204(c) (2).

We have hereinbefore pointed out that prior to the Revenue Act of 1926 depletion was computed on the basis of certain values and in the computation of this depletion it was required that the allowable deduction should be reasonable. The same provision for depreciation and depletion computation was carried over into the Revenue Act of 1926 with the exception that the authority for computing depletion on discovery value was eliminated. There was then inserted in the Revenue Act of 1926 section 204(c) (2), which authorized an arbitrary allowance for depletion in the case of oil and gas wells in a certain definite amount subject to certain limitations (50 per cent of net income).

Section 234(a) (8) cannot restrict section 204(c) (2). Since section 204(c) (2) specifies that the depletion shall

be a definite amount, that is, 27½ per cent of gross income, there is no necessity for the restriction that the amount so computed should be reasonable. It might very probably be that in the viewpoint of some reviewing bodies the depletion allowance of 27½ per cent of the gross income might not be reasonable. However, it can certainly not be argued that because of such unreasonableness the allowance authorized by section 204(c) (2) cannot be allowed, but must be subject to the restrictions of section 234(a) (8). To that extent, it must be conceded that the two sections are not to be read together.

Section 204(c) (2) itself specified the only instance and purpose in which section 234(a) (8) should be considered, and that purpose is to determine whether the depletion allowance computed under section 234(a) (8) is more or less than the allowance computed under section 204(c) (2).

Section 204 (c) (2) provides, *"in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."* It is quite clear that the allowance provided for by section 204(c) (2) shall be the lowest depletion allowance to which the taxpayer shall be entitled. If a *greater* depletion allowance is computable under any other paragraph of the statute, the taxpayer should be allowed the greater amount. However, if the depletion allowable under any other paragraph should be less than the allowance computed under section 204(c) (2), then the taxpayer shall be allowed the amount computed under section 204(c) (2). The Commissioner and the Board of Tax Appeals violate this injunction of section 204(c) (2). In effect, the Commissioner and the Board compute the allowance under section 204(c) (2)

and then reduce it by apportioning the allowance under the provisions of section 234(a) (8). Since section 204 (c) (2) provides that the depletion allowance "shall be" 27½ per cent of gross income (subject to 50 per cent of net income limitation which is not in question in this controversy) unless a *greater* allowance is computable under another section, the Circuit Court of Appeals was correct in reversing the decision of the Board which restricted the depletion allowance to this taxpayer to an amount less than 27½ per cent of the gross income.

There Is No Reason for Making Sections 234(a) (8) and Section 204(c) (2) a Part of Each Other, Since the Depletion Allowance Under Section 204(c) (2) Is Arbitrary and Distinctly Different in Nature Than the Depletion Allowable Under Section 234(a) (8).

There is no necessity for making section 234(a) (8) a part of section 204(c) (2). Under section 234(a) (8) the depletion allowable represents an annual return of a definite capital sum. Every specified basis for depletion is a specific capital sum to be returned to the taxpayer tax-free through the allowance as a deduction of the depletion allowable under section 234(a) (8). This is not true as to section 204(c) (2). This section specifies the exact amount of depletion allowance and it provides that such allowance shall not exceed 50 per cent of the net income of the taxpayer, and it provides further that such allowance *shall not be less* than it would be if computed under some other section of the statute. The very fact that the provision is so arbitrary in nature is some proof of the contention that the allowance is not intended as a

return of a definite aggregate capital value to all persons interested in oil and gas wells. The Commissioner of Internal Revenue himself recognizes this feature of the statute. In his decision promulgated IT:2327 C. B. June, 1927, page 18, the Commissioner held:

> "The *allowance* for depletion provided by section 204(c) (2) of the Revenue Act of 1926 in the case of oil and gas wells constitutes an allowable deduction under the Revenue Act of 1926 notwithstanding there is no depletable capital sum based upon cost."

This ruling is very significant, since it shows that the Commissioner himself recognizes that section 204(c) (2) specifies an *allowance* for depletion and not merely a basis for depletion. Furthermore, in his ruling, the Commissioner recognizes that this arbitrary depletion is to be allowed regardless of whether the taxpayer has any recognized capital sum remaining to be returned to him. Since this section is not designed to return to either lessor or lessee any particular capital sum, and since it shows no discrimination in cases where a lessor has a capital sum remaining and lessee has no capital sum remaining, and gives no consideration to any factors in relation to the interests of the taxpayers receiving income from oil and gas wells, we see no reason why the statute should be construed as a part of section 234(a) (8) prescribing a definite depletion allowance which must be apportioned between lessor and lessee.

3.

THE PROVISION THAT THE DEPLETION DEDUCTION IS TO BE EQUITABLY APPORTIONED BETWEEN LESSOR AND LESSEE IS NOT A PART OF SECTION 204(c) (2) BUT APPLIES ONLY TO DEPLETION COMPUTED UNDER SECTION 234(a) (8).

Regarding the above proposition, the Circuit Court of Appeals stated [R. 207]:

> "We advance, finally, to the troublesome question of equitable apportionment, so earnestly insisted upon by the Commissioner and by the Board.
>
> "As we have seen, this subject is covered by section 214(a) (9) and section 234(a) (8), *supra.*
>
> "In the first place, it is observable that both sections deal with 'mines, other natural products, and timber', as well as with oil and gas wells. They are therefore, in a sense, general provisions. It is elementary that 'General language of a statutory provision, although broad enough to include it, will not be held to apply to a matter specifically dealt with in another part of the same enactment.' *Ginsberg & Sons v. Popkin,* 285 U. S. 204, 208.
>
> "Secondly, the section specifies that the deduction—*i.e.,* the 'reasonable' deductions—*allowed by that paragraph*—shall be equitably apportioned. But that does not mean that the 'arbitrary' deduction allowed by section 204(c) (2) should likewise be 'equitably' apportioned. Here again we are confronted by the rule that all doubtful intendments should be construed in favor of the taxpayer."

The provisions of section 204(c) (2) are simple and couched in the plainest of language. It allows depletion at the rate of 27½ per cent of gross income. The Board of Tax Appeals, by reading into it portions of section 214 (234), makes it ambiguous and complicated, and injects a meaning which would necessitate intricate computations to determine the depletion allowance. This result is directly in conflict with the expressed intent of the Legislature as to the purpose of this section.

The Board's interpretation of section 204(c) (2) clearly extends its provisions beyond the import of the language used. In so doing the Board violated the fundamental rule that "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions by implication, beyond the clear import of the language used or to enlarge their operations so as to embrace matters not specifically pointed out." (*Gould v. Gould,* 245 U. S. 151.)

We believe the conclusion of the Circuit Court should be sustained.

The Board Has Erroneously Defined "Equitable Apportionment." An Equitable Apportionment of Depletion Deductions Cannot Be Arrived at by a Division of an Aggregate Depletion Allowance to a Lessor and Lessee on the Basis of Their Pro Rata Interest Under an Oil Lease.

The Circuit Court of Appeals avoided any discussion of the Board's interpretation of "equitable apportionment" by concluding that the statutory provision for equitable apportionment of the depletion deduction did not apply to the depletion allowance under section 204(c) (2).

[R. 207.] We believe the Circuit Court to be correct in this conclusion and if this Honorable Court should sustain the Circuit Court's decision on this point, the argument under this subheading is unimportant. However, if this Honorable Court should disagree with the conclusion of the Circuit Court, we respectfully submit this argument to show that the Board's interpretation of "equitable apportionment" is fundamentally unsound and creative of impractical if not impossible situations.

The Board, affirming the Commissioner's contention, concluded that a depletion deduction is equitably apportioned between lessor and lessee when an aggregate depletion allowance is divided between them on the basis of their stated interests under an oil lease. We believe the fallacy of such a conclusion can be very readily disclosed.

The provision for equitable apportionment of the depletion allowance between lessor and lessee, when first inserted in the Revenue Act of 1918, was intended to permit a lessee to deduct an allowance for the depletion of his interest (*supra*, p. 20). It was never intended to mean a division between lessor and lessee of an aggregate total annual depletion allowance for the property and the Commissioner has never so applied it. The lessor's depletion is computed separately, and the lessee's depletion is computed separately. Many factors enter into the depletion computation which might affect one party and not the other. (Note Articles 203 and 204 and 207 of Regulations 69, quoted in Appendix hereto.) Usually the lessor takes no part in and makes no expenditures for the development of the property, and thus the lessee, by building up a large cost for his interest, may be entitled to a

large amount of depletion whereas his lessor, with a very small cost for his interest, may be entitled to a comparatively small depletion allowance. A very simple example will serve to illustrate this point:

Example to Illustrate Futility of Equitable Apportionment of Aribtrary Depletion Allowance Under the Theory Adopted by the Board.

Supposing an operating lessee of an oil property and a lessor start at March 1, 1913, with a basic March 1, 1913, value to each for his respective interest in the property. Let us assume these factors to exist:

	Lessor Interest (1/8)	Lessee Interest (7/8)
Recoverable Oil Reserve	1,000,000 Bbls.	7,000,000 Bbls.
Capital Sum (3/1/13 value)	$500,000.00	$3,500,000.00

The unit of depletion in each case is 50 cents per barrel —in other words, the return of capital or depletion allowance is 50 cents on each barrel produced. Now let us assume that in 1925 the operating lessee has added $700,000 to his costs for development, and that the following factors exist for 1926:

Remaining Recoverable Oil Reserve	500,000 Bbls.	3,500,000 Bbls.	
Remaining Capital Sum	$250,000.00	$1,750,000.00	
		plus 700,000.00	added in 1925
		$2,450,000.00	
Depletion Unit (Remaining Capital Sum ÷ Remaining Reserves)	.50	.70	
1926 Production	10,000 Bbls.	70,000 Bbls.	
Depletion Allowable (Sec. 214)	$5,000.00	$49,000.00	

Let us also assume that $1.00 per barrel sales price was received for the oil sold in 1926, or, $80,000 gross proceeds from all oil sold.

Under section 204 (c) (2) under the Board's decision in this *Twin Bell* case, the depletion would be 27½ per cent of $80,000, or $22,000 to be apportioned ⅛ or $2,750.00 to the lessor and ⅞ or $19,250.00 to the lessee.

By this computation, it is evident that an equitable apportionment of depletion under section 214 or 234 shows the lessee to be entitled to a depletion of almost 10 times that to which the lessor is entitled. Yet under the Board's construction, the equitable apportionment of depletion computed under section 204 (c) (2) would entitle the lessee to but 7 times more depletion than the lessor.

To arrive at a true "equitable apportionment" to all parties interested in an oil property of a definite depletion deduction which under the Board's theory cannot in the aggregate exceed 27½ per cent of the total proceeds of the property, would involve the very intricate computations which it was the Legislature's intention to avoid when it enacted section 204 (c) (2). There may be a number of persons receiving royalties from an oil property and their interests in the property may vary from percentages of gross income to percentages of net income. In such a case it would be practically impossible to determine a depletion allowance under the method prescribed by the Board.

In the discussion of the above example we have made no mention of the restriction contained in section 204 (c) (2) that the depletion allowance cannot exceed 50 per cent of the net income. This restriction, however, should be kept in mind. It may be that a lessee will have no net income while a lessor's net income may be its gross income.

It is obvious, therefore, that there was not intended that there should be such an apportionment of allowable depletion deductions that the amounts allowed to lessor and lessee should add to a predetermined definite aggregate depletion allowance. Unless the lessor or lessee or anyone else having an interest in the oil property realizes a net income, he can receive no depletion allowance under section 204 (c) (2), unless he is entitled to a depletion deduction under section 234 (a) (8), to which he would be entitled by virtue of the provision in section 204 (c) (2) that in no case is the depletion deduction to be less than if computed without reference to that paragraph.

Further Example to Illustrate Board's Failure to Properly Analyze Concept of Section 204(c) (2).

Supposing that a lessor and lessee agree that the lessee will pay a royalty of 25 per cent of the *net income* from the property, and that during a taxable year the following factors exist:

Gross proceeds from sale of oil	$200,000.00
Net income—before computing royalty	$ 80,000.00
Royalty—25% of $80,000.00	$ 20,000.00
Net income after deducting royalty	$ 60,000.00

Under the Board's theory the depletion under section 204 (c) (2) would be 27½ per cent of $200,000.00 or $55,000.00 to be apportioned as follows:

Lessor—25%	$ 13,750.00
Lessee—75%	26,250.00

and the depletion allowable to both lessor and lessee would be as follows:

Lessor:		
27½% depletion	$13,750.00	
50 % of lessor's net income ($20,000.00) Limitation Sec. 204 (c) (2)	10,000.00	
Depletion allowable under theory of Board decision		$10,000.00
Lessee:		
27½% depletion	$26,250.00	
50 % of lessee's net income ($60,000.00)	30,000.00	
Depletion allowable under theory of Board's decision		$26,250.00

We have hereinbefore pointed out that under court decisions, the gross proceeds realized by an operating lessee from the sale of oil constitute gross income to him, and that rents or royalties paid to a lessor represent gross income to him. Yet, under the Board's theory, as applied to the above illustration, the depletion allowable to the lessor would be based on a portion of the lessee's gross income and would be $10,000.00 (or 50% of his net income), although the lessor's gross income was but $20,000.00, and 27½% of $20,000.00 is but $5,500.00. This is in direct violation of section 204 (c) (2), which states the depletion allowance shall not exceed 27½% of the gross income from the property. It must be granted that logic and the general form of construction of Revenue

Statutes require the interpretation of section 204 (c) (2) to mean that that section applies to each taxpayer independently of its application to any other taxpayer. And it must logically follow that the term "gross income from the property" must mean the gross income realized by the taxpayer who is claiming a depletion deduction under that section, from the property.

A lessor realizes the amount of his royalty as his gross income from the property (*supra*, p. 16). The Board's theory causes a direct violation of this law, since under the Board's theory the lessor's gross income from the property upon which the 27½ per cent would be computed would be some arbitrary *apportionment* of another taxpayer's gross income.

Would it not be a simple matter and more in harmony with the intent of the Legislature when it enacted section 204 (c) (2) if the following solution to the above illustration could be made by each taxpayer:

	Lessor	Lessee
Gross income from property	$20,000.00	$200,000.00
Net income from property	20,000.00	60,000.00
27½% of gross income	5,500.00	55,000.00
50 % of net income	10,000.00	30,000.00
Depletion allowable under Section 204 (c) (2)	5,500.00	30,000.00

And each taxpayer could compile his own tax return without the necessity imposed by the Board decision of inquiring from the operating lessee the record of income

from the well and the method of "apportionment" of a depletion deduction to be computed against that income.

The Board's theory of the concept of section 204 (c) (2) is that it allows a gross depletion allowance to groups of taxpayers and not to individual taxpayers; and that the term "gross income" as used therein means the gross income realized by the taxpayer who is the operator of the business in which the group is interested. This is, of course, contrary to the fundamental concept of the Revenue Statutes, which are intended to prescribe the gross income deductions, taxable net income, and tax of *each* taxpayer, and certainly do not authorize the computation of a deduction based on another taxpayer's income.

Under the Board's theory, each person interested in an oil well will be obliged to learn from the taxpayer who operates the well what *that taxpayer's* gross income from the well amounts to, before he can compute his depletion allowance, and he then deducts his share of the depletion based on another taxpayer's gross income regardless of the amount of his own gross income. This could not have been intended in a statute enacted for the purpose of simplifying the computation of depletion. Nor is it reasonable that a taxpayer must compute his deductions on the basis of the gross income of another taxpayer.

4.

AMENDMENT CONTAINED IN SECTION 114(b)(3) OF REVENUE ACT OF 1932 IS NEW LAW.

Congress must have appreciated the force of the contention now being made by this petitioner. In the 1932 Revenue Act, section 114 (b) (3) which corresponds to section 204 (c) (2) of the Revenue Act of 1926 and section 114 (b) (3) of the Revenue Act of 1928, reads:

> "In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, *excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.*"

The portion in italics is a new provision not contained in the earlier acts. Since it is a provision for exclusion of matter otherwise included in the general language of the rest of the section, it must be construed as an amendment of the old law and not a declaration of the meaning of the old law.

The deliberate selection of language so differing from that used in the two earlier Revenue Acts indicates that a change of law was intended. Ordinarily, statutes establish rules for the future, and they will not be applied retrospectively unless that purpose plainly appears. *U. S. v. Magnolia Co.*, 276 U. S. 160, 162; *Brewster v. Gage*, 280 U. S. 327; *Russell v. U. S.*, 278 U. S. 181.

There is no indication in the Legislature Reports on the Revenue Bill of 1932 that section 114 (b) (3) as amended in the Revenue Act of 1932 was to be given retrospective effect.

It would therefore appear that the earlier statutes permitted a depletion allowance of 27½ per cent of gross income without exclusion from that gross income the amounts of royalties paid.

The Circuit Court of Appeals was correct in its conclusion that—

> "It will be observed that, with the exception of the provision for the exclusion of rents or royalties, the 1932 enactment is identical with the corresponding section of the Revenue Act of 1926, section 204 (c) (2), *supra*. This new qualifying phrase, not found in the Act of 1926, amounts, it would seem, to a legislative interpretation of the Act of 1926 as *not* excluding rents or royalties from gross income. It is at least a legislative recognition that the language used in the 1926 section was ambiguous. And if ambiguity exists, it must be resolved in favor of the taxpayer.
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> * * * * * * * *
>
> "So here we believe that the 'change of phraseology' in the 1932 Act is 'significant' of the legislative construction of the Act of 1926."

The Amendment as Contained in Section 114(b) (3) of the Revenue Act of 1932, Disproves the Board's and Commissioner's Theory as to the Depletion Allowance Intended by Section 204(c) (2) of the Revenue Act of 1926.

The Board held that because section 234 (a) (8) contained the provision that the depletion allowance must be equitably apportioned between lessor and lessee, it became a part of section 204 (c) (2) and therefore the depletion allowance of 27½ per cent of the gross income from the

property must be apportioned between lessor and lessee according to their proportionate interest under the lease.

Section 23 (1), Revenue Act of 1932, still contains the provision for equitable apportionment of the depletion deduction between lessor and lessee. So, under the Board's theory, it must still be considered as a part of section 114 (b) (3) of the Revenue Act of 1932, and it would still be necessary to apportion the depletion allowance computed under section 114 (b) (3).

It is obvious that Congress intended to reduce the gross income upon which a lessee under the previous laws had the right to compute the 27½ per cent depletion allowance, and the amendment has exactly that effect if the amended section is interpreted as meaning each taxpayer may take 27½ per cent of his gross income from the property reduced by royalties paid. But it would not have that effect if the Board's theory is followed because under the Board's theory it would still be necessary to take the gross income from the property, exclude therefrom royalties paid, compute 27½ per cent on the remainder, to arrive at the depletion allowance, and then apportion the resulting depletion allowance between lessor and lessee. Such a construction is not consistent with the ordinary meaning of the language used in the statute (*Gould v. Gould, supra*) and violates the expressed intent of the Legislature to provide by this allowance of a purely arbitrary amount, a simple means of computing a depletion allowance for each taxpayer interested in oil and gas wells; and it further violates sound tax principles by establishing a deduction to one taxpayer based on another taxpayer's gross income.

5.

EVERY TAXPAYER HAVING INTEREST IN OIL PROPERTY IS ENTITLED TO COMPUTE ITS SEPARATE ALLOWANCE BY APPLYING SECTION 204(c) (2).

In the case of *Palmer v. Bender,* 77 L. Ed. (Adv. Op.) 338, the United States Supreme Court held that every person having an economic interest in the oil reserve is entitled to a deduction for depletion. Each taxpayer, therefore, having such an interest is entitled to take 27½ per cent of his gross income from the oil property as his allowance for depletion under section 204 (c) (2). He is not obliged to make a computation of his proportion of any total aggregate depletion allowance which is to represent a maximum allowance to be apportioned between those persons having an interest in the property. He will show his receipts from the oil property as his gross income; he will take therefrom his deductions to arrive at his net income from the property; he will then compute his 27½ per cent of his gross and, if that figure is not in excess of 50 per cent of his net income, it will represent his depletion allowance under this section.

We respectfully submit that this conclusion is supported by the wording of section 204 (c) (2), by the manner in which Congress amended this section in section 114 (b) (3) of the Revenue Act of 1932, and by the expressed intent of Congress that this section should provide a simple means of computing the depletion allowance.

Against this conclusion the Commissioner argues "Congress intended to allow for depletion a flat 27½ per cent of the total income produced by the well, irrespective of to whom this income was attributable; that in the case of

leases this total allowance is to be apportioned equitably between the lessor and lessee," on the basis of their respective interests in the property.

That the Commissioner's argument is not convincing can readily be demonstrated. It is not uncommon to have a number of persons receiving royalties from one property—some having a percentage of gross receipts, some having a percentage of gross receipts after payment of landowner's royalty, and some sharing in the net income after payment of all other royalties and expenses. It would be almost impossible to "equitably apportion" a depletion allowance in such a case by the methods of computation contended for by the Commissioner and the Board. As a further illustration of the fallacy of this argument, we have hereinbefore discussed an example of application of the Commissioner's contention which shows a result unquestionably violative of the provision of the statute (*supra*, p. 35).

In its reports of the Revenue Bill of 1926 (*supra*, p. 21), Congress did express itself to the effect that section 204 (c) (2) was enacted for the purpose of providing a simple means of determining the depletion allowance, and of avoiding intricate computations. If the Commissioner's contention converts the clear and simple language of section 204 (c) (2) into a number of complicated innuendoes, and converts the simple means for computing depletion provided for in the unambiguous terms of the statute, into a formula involving intricate computations, the expressed intention of Congress in favor of simplicity is sufficient in itself to refute the Commissioner's contention.

Even if there should be any doubt as to the interpretation of the provisions of this statute (section 204 (c) (2)) or as to the connotation of the terms used, and another meaning might be adopted, the fact of their use in a tax statute would incline the scale to the construction most favorable to the taxpayer.

Gould v. Gould, supra;

United States v. Updike, 281 U. S. 489;

Burnet v. Niagara Falls Brewing Co., 282 U. S. 648.

This petitioner submits that section 204 (c) (2) of the Revenue Act of 1926 applies to it as an individual taxpayer, and authorizes it to compute its depletion deduction on the basis of 27½ per cent of its gross income, with the restriction that such allowance shall not exceed 50 per cent of its net income. There is nothing in the statute to compel this petitioner to share *its* depletion allowance with anyone else interested in the property. All other persons interested in the oil property are entitled to compute their depletion allowance under section 204 (c) (2) by taking 27½ per cent of their respective gross income from the property. There is no 100 per cent depletion allowance under this section, to which all parties interested are entitled to a pro rata benefit, and which *after having been computed,* must be "apportioned" amongst the parties interested. The section merely provides a percentage depletion allowance to which each taxpayer is entitled based on his own gross and net income from the oil and gas property.

Conclusion.

The judgment of the court below is correct and should be affirmed.

Respectfully submitted,

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APPENDIX.

Statutes Involved.

REVENUE ACT OF 1926:

Section 204 (a).

"The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—"

Section 204 (b).

"The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property (or, in the case of such property as is described in paragraph (1), (4), or (5), of subdivision (a), the basis as therein provided), or (B) the fair market value of such property as of March 1, 1913, whichever is greater. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date."

Section 204 (c).

"The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—"

Section 204 (c) (2).

"In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allow-

ance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." (Section 114 (b) (3) of the Revenue Act of 1928 contains the same provision of Section 204 (c) (2) of the Revenue Act of 1926 above quoted.)

REVENUE ACT OF 1932:

Section 114 (b) (3).

"Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

REVENUE ACT OF 1926:

Section 212 (a), (232 (a)).

"In the case of an individual the term 'net income' means the gross income as defined in section 213, less the deductions allowed by sections 214 and 206."

Section 233 (a).

"In the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in sections 213 and 217. . . ."

Section 213.

"For the purposes of this title, except as otherwise provided in section 233

(a) The term 'gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period."

Section 214 (a) (and 234 (a) (1)).

"In computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually ren-

dered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity; . . ."

Section 214 (a) (9) (and Sec. 234 (a) (88)).

"In computing net income there shall be allowed as deductions:

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; . . ."

REVENUE ACT OF 1932:

Section 23 (1).

"*Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than

the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitable apportioned between the lessor and lessee. . . ."

REGULATIONS 69 (Relating to Revenue Act of 1926):

Article 221.

"Under Section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or the value at the basic date, as the case may be. . . ."

Article 203.

"*Amount returnable through depletion and depreciation deductions in the case of lessee.*—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions and minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (4) the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation. The pro-

visions of this paragraph do not apply to the computation of the depletion allowance in the case of oil and gas wells when such allowance is based on the income from the property.

(b) The values of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is to be taken to mean (1) its cost or (2) the value of his interest in the mineral as of that date, whichever is greater.

(d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is to be taken to mean its cost.

(e) The value of a lessee's equity in a discovery after February 28, 1913, is the fair market value at date of discovery, or within 30 days thereafter, of his equity in the mineral discovered."

Article 204.

"*Amount returnable through depletion and depreciation deductions in the case of lessor.*—(a) In the case of a lessor, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value of his equity in the property at the basic date minus (2) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, plus (3) subsequent allowable capital additions, and minus (4) the value of the land at the basic date for other purposes than mineral production and the residual value of other property at the end of operations. The amount re-

turnable through depletion is the total capital remaining less the sum recoverable through depreciation. The provisions of this paragraph do not apply to the computation of the depletion allowance in the case of oil and gas wells when such allowance is based on the income from the property.

(b) The values of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(c) The value of the lessor's equity in the case of a mineral property not under lease on March 1, 1913, but subsequently leased, is to be taken to mean (1) the cost or (2) the *en bloc* value of the mineral in the ground on March 1, 1913, whichever is greater, and will, in the absence of satisfactory evidence to the contrary, be presumed not to exceed the value as of March 1, 1913, of the royalties to be expected under the lease.

(d) The value of a lessor's equity in a mineral property under lease March 1, 1913, for the entire operating life of the mineral deposits is to be taken to mean (1) the cost of (2) the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date, whichever is greater.

(e) The value of a lessor's equity in a mineral property under lease March 1, 1913, for a portion of its operating life is to be taken to mean (1) the cost or (2) the value as of March 1, 1913, of the royalties expected from the mineral to be extracted during the life of the existing lease plus the estimated *en bloc* value of the mineral remaining at its expiration, which, in the absence of satis-

factory evidence to the contrary, will be presumed not to exceed the value as of March 1, 1913, of royalties which could have been expected as at that date from the remaining mineral.

(f) The value of a lessor's equity in a mineral property when acquired on or after March 1, 1913, is to be taken to mean its cost.

(g) The value of a lessor's equity in a discovery after February 28, 1913, is the fair market value at the date of discovery, or within 30 days thereafter, of his equity in the mineral discovered."